Internal Revenue Service
memorandum

CC:TL-N-5165-88
Brl:VLDraper

date: JUN 23 1988

to: District Counsel, [redacted]

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to the request for informal technical advice by Michael Goldbas in March 1988. After several conversations and submission to the National Office of background materials, it was determined to respond to the request as a formal technical advice.

ISSUES

1. Whether petitioner's method of accounting is a Category A or Category B method under Rev. Proc. 84-74, 1984-2 C.B. 376. 0481-0000.

2. Whether I.R.C. § 446(e) shields taxpayers from penalties imposed under the Code for failure to change voluntarily to a proper method of accounting. 0446-1900.

CONCLUSIONS

1. The change in petitioner's method of accounting is a Category A change under Rev. Proc. 84-74, 1984-2 C.B. 376, because the method petitioner used was a clearly erroneous one.

2. Section 446(e) is not a shield against penalties imposed under the Code for failure to change to a proper method of accounting. Consequently, petitioner is subject to such penalties.

FACTS

On [redacted], [redacted] ([redacted]) acquired all the stock of [redacted] ([redacted]), [redacted]. [redacted], the petitioner, was the sole shareholder of [redacted] and is its president and Chairman of the

Board. Following the acquisition, [redacted] was liquidated pursuant to I.R.C. §§ 332 and 334(b)(2). A final short period tax return was filed for the corporation for the seven month period ending [redacted]. This return used an ending inventory figure of $[redacted], resulting in a net operating loss of approximately $[redacted]. The carryback of this loss allowed petitioner to recoup approximately $[redacted] in federal and state tax refunds.

Petitioner computed the ending inventory figure for [redacted] based upon the method of accounting used for many years by the previous owners. This method consisted of applying a percentage to sales to establish cost of goods sold with the difference between purchases and cost of goods sold being attributed to inventory (hereinafter referred to as petitioner's method of accounting or the percentage method). Physical inventories were not taken.

During an audit, however, the revenue agent [redacted]. As a result of this discovery, the Service claimed that this count clearly indicated that the reported inventories were understated and has assessed a deficiency. As the physical count was knowingly ignored by petitioner, the Service is also seeking a civil fraud penalty. [redacted]

DISCUSSION

Section 446(b) provides that if the method of accounting used by a taxpayer does not clearly reflect income, the computation shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. Treas. Reg. § 1.446-1(a)(1) provides that the term "method of accounting" includes not only the over-all method of accounting of the taxpayer, but also the accounting treatment of any item. Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides that a change in the method of accounting includes a change in the overall plan of accounting for gross income or in the treatment of any material items. It also includes a change in the method or basis used in the valuation of inventories. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Section 446(e) provides that the consent of the Secretary shall be obtained by a taxpayer before changing his method of accounting. Section 446(f) provides that if the taxpayer does not file with the Secretary a request to change the method of accounting, the absence of the consent of the Secretary to a change shall not be taken into account to prevent the imposition of any penalty for underpayment of taxes.

Section 471 provides as a general rule that when the use of inventories is necessary in order clearly to determine income, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. Treas. Reg. § 1.471-2(a) provides that each inventory must clearly reflect income. Treas. Reg. § 1.471-2(b) provides that while greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation, such weight is given only so long as the method or basis used is in accord with Treas. Reg. §§ 1.471-1 through 1.471-11.

Treas. Reg. § 1.471-2(d) provides that where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased, the net value as shown will be deemed to be the cost. These balances should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Treas. Reg. § 1.471-3(a) provides that valuing inventories at costs means in the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods. In the case of inventory purchased during the year, cost means the invoice price less trade or other discounts.

Section 481 provides that if a computation of taxable income for any taxable year is under a method of accounting different from the method used the previous year, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. Treas. Reg. § 1.481-1(a)(2) provides that in a situation where the change in method of accounting is not initiated by the taxpayer, no part of the adjustments required by this section shall be based on amounts which were taken into account in computing income for taxable years beginning before January 1, 1954. Treas. Reg § 1.481-1(c)(3) provides that if the change in method of accounting is not voluntary (that is, not initiated by the taxpayer), only the adjustments required by section 481(a) which are attributable to taxable years subject to the 1954 Internal Revenue Code are taken into account in computing taxable income for the taxable year of the change. Treas. Reg. § 1.481-1(c)(4) provides that in the case of an involuntary change in method of accounting, no adjustments attributable to pre-1954 Code years are taken into account, whether or not such adjustments would decrease taxable income. Section 481(c) provides that in the case of any change described in subsection (a), the Secretary may prescribe the manner by which adjustments required by subsection (a)(2) are to be taken into account by the taxpayer for the taxable year or years permitted under the regulations. In Rev. Proc. 84-74, 1984-2 C.B. 376, the Service has so prescribed the manner.

The Service is in accord with the taxpayer's position on preliminary matters. First, we agree that taking into account the physical count of inventories at retail, adjusted to cost, in order to determine ending inventory is a change in a method of accounting within the meaning of sections 446(e) and 481. See Primo Pants Company v. Commissioner, 78 T.C. 705 (1982). Second, we agree that as the taxpayer was not on the perpetual inventory method as described in Treas. Reg. § 1.471-2(d), he cannot be required to adjust his inventory calculation to conform to the physical count under the authority of that regulation. Next, we are in accord with the taxpayer that if the ending inventory for [redacted] is required to be adjusted for the physical count, then so also must be the beginning inventory in order to reflect the same basis. See Fruehauf Trailer Company v. Commissioner, 42 T.C. 83 (1964), aff'd, 356 F.2d 975 (6th Cir. 1966); cert. denied, 385 U.S. 822 (1966); Primo Pants Company v. Commissioner, 78 T.C. 705, 725-26 (1982); Superior Coach of Florida v. Commissioner, 80 T.C. 895, 911 (1983). Finally, we agree that transitional adjustments resulting from this change are to be taken into account under section 481.

We disagree with the taxpayer, however in the following issues. The taxpayer's percentage method of accounting is a clearly erroneous one. Consequently, under the authority granted to the Commissioner by Congress under section 481(c), the taxpayer is required to account for all of the adjustment resulting from the change of accounting in the year of change. Second, the taxpayer is not shielded under section 446(e) from the requirement that it initiate a change from an erroneous method of accounting to a proper method. Thus, petitioner is liable for penalties imposed under the Code.

Issue 1:

The Secretary has the authority to correct a method of accounting which does not clearly reflect income. Under section 471(a), when the use of inventories is necessary, as they are in petitioner's case, the taxpayer is required to take such inventories on a basis which most clearly reflects income. Section 446(b) provides that if the method of accounting used by a taxpayer does not clearly reflect income, the computation shall be made under such a method as the Secretary determines does clearly reflect income.

Petitioner's manner of accounting for inventories was a clearly erroneous method which did not clearly reflect income. Petitioner accounted for inventories by using a percentage of sales to establish cost of goods sold with the difference between purchases and cost of goods sold being attributed to inventory. This is not a method of accounting for inventories sanctioned in the regulations. Treas. Reg. § 1.471-2(f).

Furthermore, [redacted]. Because of this significant difference, the percentage method of calculating inventories did not clearly reflect income and can be changed by the Secretary.1/

The correction of the [redacted] ending inventory figure is a change in a method of accounting initiated by the Commissioner. Petitioner's method of accounting for inventory under the percentage method, even though an erroneous one, was a method of accounting. Fruehauf Trailer Co. v. Commissioner, 42 T.C. 83, 104 (1964), aff'd, 346 F.2d 976 (6th Cir. 1966), cert. denied, 385 U.S. 822 (1966). The term "method of accounting" includes the overall method of accounting and also the accounting treatment of any particular item. Treas. Reg. § 1.446-1(a).

A change in a method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item which involves the proper time for the inclusion of an item in income or the taking of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a). The change to the use of a physical inventory is a change that affects the timing of the cost of goods sold deduction and therefore constitutes a material item within the meaning of the Treasury regulations. See Primo Pants Co. V. Commissioner, 89 T.C. 704, 723-724 (1982).

A change of accounting for purposes of section 481 includes, at least, a change in the treatment of a recurring material item. Treas. Reg. § 1.481-1(a)(1); Coors v. Commissioner, 60 T.C. 368, 400 (1973), citing Shepherd Construction Co. v Commissioner, 51 T.C. 890, 898 (1969); Fruehauf Trailer Co. v. Commissioner, 42 T.C. 83, aff'd, 356 F.2d 975 (6th Cir. 1966), cert. denied, 385 U.S. 822 (1966). In Fruehauf, the Commissioner changed the inventory of 3428 used trailers from $1 each to $5.4 million. The court considered this a change in the "treatment of a material item" and therefore this was a "change in the method of accounting" as that term is used in section 481. Thus, under the authority of these cases, petitioner's inventory valuation is a material item, a change in which is a

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1/ We agree that the authority to make the correction is not under Treas. Reg. § 1.471-2(d) as petitioner was not on a perpetual method of accounting for inventory.

change of method of accounting under section 481. A change in method of accounting to which section 481 applies includes a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item.

Section 481(c) gives the Secretary the authority to determine the method by which and the period in which adjustments under section 481(a) are to be taken into account. In general the adjustment period is designed to ameliorate, at least in part, the otherwise distortive effect of the section 481(a) adjustment. Pursuant to implementing this statute, the Service issued Rev. Proc. 84-74, 1984-2 C.B. 376.

In order to encourage taxpayers to voluntarily adopt proper methods of accounting, the Service will not allowing an adjustment period of more than one year in some situations. Of relevance to petitioner's case, Rev. Proc. 84-74, supra, provides that the section 481 adjustment must be made in one year when the method to be changed is a Category A method of accounting, as defined in the revenue procedure, and the taxpayer has been contacted in any manner by a representative of the Service for the purpose of scheduling an examination or the taxpayer is before any federal court with respect to an income tax issue unless the taxpayer has obtained an agreement from counsel for the government that there is no objection to the taxpayer requesting a change in the method of accounting.

Taxpayer's percentage method was a "clearly erroneous" Category A method. Rev. Proc. 84-74, supra, Sec. 6. First, the percentage method is not a method of inventory valuation sanctioned by the Code. Section 471 of the Code requires that the inventory must clearly reflect the income of the taxpayer. Section 1.471-2(e) states that inventories should be properly computed and summarized, and should be preserved as a part of the accounting records. The methods of inventory valuation that are specifically authorized in the Code and regulations are (1) cost and (2) cost or market, whichever is lower, both of which are cost-based methods.

The taxpayer's percentage method is not a cost-based method or an otherwise proper method of computing the value (prices) of the goods in inventory. It is simply a method of computing a value for the inventory using an estimating technique, the result of which bore no relationship to the proper cost (or market, if lower) of the goods in inventory. Accordingly, the percentage method is a clearly erroneous method of valuing inventory.

Additionally, the taxpayer's percentage method of computing the estimated value of its inventory did not incorporate a proper method of identifying the cost of the items in the inventory. If the items can be identified and related to their cost, such actual cost (or market, if lower) may be used to value the items. If they cannot be so identified, then costs must be computed by first-in, first-out (FIFO) method, unless the elective last-in, first-out method has been adopted. The taxpayer's percentage method is only capable of computing an estimated value of inventory based on a presumed average cost of goods sold derived from an average estimated profit margin.

The percentage method did not result in the computation of either cost or cost or market, whichever is lower, in the manner required by the regulations dealing with FIFO. Taxpayer's method is not a FIFO, lower of cost or market valuation method despite the apparent use of such label on the corporation's tax returns. Cost means the inventory price plus freight-in costs of such goods. Treas. Reg. § 1.471-3. The regulations make clear that price refers to invoice price less allowable discounts, not to some approximation of price as in petitioner's percentage method. Nor has petitioner been able to satisfy the district director of the correctness of the prices adopted. Treas. Reg. § 1.471-2(e). 2/

Furthermore, in applying the gross percentage method and ignoring cost as physically counted, petitioner has specifically used a method the revenue procedure considers to be within Category A: petitioner's stating its inventory at less than its proper value, Treas. Reg. § 1.471-2(F)(2), and petitioner's write-down of goods in inventory did not comply with Treas. Reg. § 1.471-2(c), that is, it was written down without being sold or offered for sale at the reduced price. Rev. Proc. 84-74, supra, sec. 6.02(4)(2). If petitioner argues its goods are valued at market, its method is again specifically considered erroneous under the revenue procedure as petitioner wrote down goods without complying with Treas. Reg. § 1.471-2(b). Petitioner made no attempt to provide any evidence of the fair market value of the goods in the inventory at issue. General industry studies are not appropriate evidence.

Additionally taxpayer's method is clearly erroneous because the effect of the method was to write down inventory to what was considered a net realizable value although such inventory was not scrapped, sold or offered for sale at the reduced price. See Thor Power Tool Company v. Commissioner, 439 U.S. 522 (1979), and Treas. Reg. § 1.471-4(b). Rev. Proc. 84-74, supra, at sec. 6.02(4)(4).

Rev. Proc. 84-74, supra, lists the ways in which a taxpayer can establish that its method of accounting is not clearly erroneous. Petitioner is not able to do so. It cannot show that the method is acceptable under any currently recognized pronouncement, opinion or rule published by the accounting professions; that the method is acceptable under any current accounting convention; that the method is acceptable under current general application of materiality or that the method

2/ Nor is the percentage method the retail method as described in Treas. Reg. § 1.471-8.

has been identified as acceptable in a document published by the Service.

The policy of the Service as pronounced in Rev. Proc. 84-74, supra, clearly shows that petitioner's method of accounting was clearly erroneous. In accordance with the revenue procedure, therefore, all of petitioner's adjustment must be accounted for in the year of change. Section 481 granted to the Service the authority to make this determination. The fact that the percentage method was applied consistently is of no avail to petitioner. Consistency is an important factor in determining the proper inventory valuation only when the method of accounting used consistently is proper. This was not the situation in petitioner's case.

Issue 2:

Given that the percentage method of accounting was erroneous, the onus to change it fell squarely on petitioner. His failure to voluntarily make this change means he is liable for penalties imposed under the Code. By continuing to use an improper method of accounting, petitioner knowingly overstated its cost of goods sold, thereby taking an unwarranted deduction for the excess amount. As such it ignored the applicable law and regulations in the preparation of the return, making petitioner liable for penalties. See e.g., 6653(a).

Petitioner on the other hand argues that prior to the effective date of section 446(f), for tax years beginning after July 18, 1984, it did not have an obligation to seek consent to change an erroneous method of accounting and therefore is not subject to penalties for continuing to use the erroneous method.

Section 446(e) provides that a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary. Some taxpayers argued there was no requirement to request permission to change from an improper to a proper method of accounting because of this section. They asserted the failure of the Secretary to consent to a change in method because it had not been requested was a defense to any penalty arising form the use of the improper method.

Because Congress "believed that [this] interpretation placed on prior law by taxpayers with improper method of accounting might have created an unintended protection against penalties for taxpayers," Congress enacted section 446(f). Conference Report, H. R. Rep. 98-861, 98th Cong., 2d Sess. 1002 (1984). Section 446(f) provides that if a taxpayer does not file with the Secretary a request to change the method of accounting, the absence of consent shall not be taken into account to prevent or diminish the amount of any penalty. The Conference report asserted "no inference be drawn with respect to the validity of the defense asserted by some taxpayers under prior law." Id. By this latter statement, Congress expressly preempted any arguments that section was a codification of existing law or that it was a change in existing law.

In light of this legislative history, it is clear that section 446(e) was never meant to be a shield against the imposition of penalties for taxpayers using erroneous methods of accounting. Congress explicitly recognized in enacting section 446(f) that the interpretation placed on section 446(e) to make it a shield was not what Congress had intended. Nor is there anything in the language of section 446(e) which would support petitioner's distorted interpretation of that section. Further, petitioner's interpretation would be contrary to public policy. In effect, petitioner is arguing that one taxpayer which negligently or fraudulently omits large amounts of income through an accounting method is in a protected position when compared to a taxpayer that omits similar amounts through a practice that cannot be characterized as an accounting method. It is folly for petitioner to argue such an interpretation without benefit of statutory language or legislative history.

In general, taxpayers have a duty to file correct returns. Section 6653; Leroy Jewelry Company, Inc. v Commissioner, 36 T.C. 443, 445 (1961); Ma-Tran Corp. v. Commissioner, 70 T.C. 158, 163 (1978); United States v. Norton, 250 F.2d 902 (5th Cir. 1958). The establishment of the consent provisions of section 446(e) were never intended to shield taxpayers from that duty, thereby relieving them of associated penalties. Rather, the purpose of these provisions was to provide the Commissioner with the authority to monitor changes in methods of accounting, to ensure that no duplication or omission of items of income or expense resulted, and to allow the Commissioner to obtain agreement as to the terms and conditions under which a change will be effected.

That provisions of section 446(e) were never intended either to shield taxpayers from the penalty consequences of using, or create penalty consequences by forcing taxpayers to use a method of accounting that substantially misstates income is indicated by the language and purpose of the statute. This language is specific, and the purpose of the statute is not subject to reasonable doubt. The statute only addresses the positive requirement that taxpayers obtain consent to change methods of accounting. There is nothing in the language or the legislative history which would justify extending the statute to serve as a shield against penalties for taxpayers who use erroneous accounting methods. No authority or logic supports this negative inference.

Tax laws must be given a reasonable construction. Alexander v. Cosden Pipe Line Co., 290 U.S. 484 (1934). A statute will not be extended to include situations by implication when its language is specific and not subject to reasonable doubt. United States v. Rice, 327 U.S. 742 (1947). To extend section 446(e) to have it serve as a shield would be an unreasonable construction of the language of the statute.

Petitioner argues that interpreting section 446(e) as a shield is logical when the Congressional intent behind section 481 is examined. Section 481 was enacted to insure that a change of accounting method would not result in a double omission from or a double inclusion in income. Section 481(a)(2) provides that no adjustments will be made under the statute for any years prior to the enactment of the statute in 1954 unless the change is initiated by the taxpayer.

Petitioner's argument appears to be that as Congress inserted section 481(a)(2) to allow a forgiveness of pre-1954 amounts for involuntary changes in methods of accounting, the only instance when the Service would have compelled a taxpayer to change its method of accounting where the Service would suffer from a whipsaw resulting from the lack of a transitional adjustment were cases where the taxpayer's prior method was erroneous. Petitioner argues that as this would undoubtedly be the practical universe of taxpayers that would be eligible for the pre-1954 balance forgiveness under the 1954 Code, therefore Congress must have felt that the taxpayers using an erroneous method of accounting should be given the choice of voluntarily requesting permission to change to a proper method of accounting or of remaining on the erroneous method until compelled to change by the Service on audit.

Petitioner misses the point. First of all, the restriction on adjustments for pre-1954 periods for involuntary changes under section 481 was intended to prevent the statute from being retroactive. In order to prevent taxpayers from taking advantage of the pre-1954 limit, however, Congress limited this the restriction in 1958 to involuntary changes to prevent taxpayers from taking advantage of a windfall of the shield from any pre-1954 adjustments and thereby abusing the system. S. Rep. No. 1938, 85th Cong. 2d Sess. (1958); H. Rep. No. 775, 85th Cong. 1st Sess. 1958; Pub. L. No. 85-866, § 29(a).

Given this change to prevent the perceived abuse, it would be absurd to argue that Congress meant to turn around and shield those who did not correct an erroneous accounting method voluntarily from penalties. There is no evidence that Congress did not intend to place taxpayers in a position where they would have to balance out the risk of penalties for failure to file an accurate return against the cost of having pre-1954 accounting periods taken into account in determining transitional adjustments.

To accept petitioner's argument that it is shielded from penalties by section 446(e) is to conclude that Congress condoned knowingly staying on an erroneous method of accounting. Such a conclusion is contrary to section 446(b) which requires that taxpayers use a method of accounting which clearly reflects income. Further, as the Commissioner cannot refuse to allow a change of method of accounting from an erroneous one to a correct method, National Bank of Fort Benning v. United States, (M.D. Ga. 1979), 1979-2 U.S.T.C. par. 9627, so a taxpayer cannot argue that it can remain on an erroneous method of accounting with impunity until forced to change to a correct method by the Commissioner. To conclude otherwise would be to undermine the principle of voluntary compliance upon which the tax system is based. See United States v. Generes, 405 U.S. 93 (1972).

If you have any questions on the above, please contact Virginia Draper, FTS 566-3521.

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